Publications and Other Research

Federal Reserve Bank of New York
Research and Statistics Group

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Federal Reserve Bank of New York
Research and Statistics Group
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February 2012

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Introduction

The Federal Reserve Bank of New York's Research and Statistics Group produces a wide variety of publications, blog posts, and discussion papers of interest to business and banking professionals, policymakers, academics, and the general public.

This catalogue lists the 2011 releases in our chief research series:

- *the Economic Policy Review*
  a policy-oriented journal focusing on economic and financial market issues
- *Current Issues in Economics and Finance*
  concise studies of topical economic and financial issues
- *Second District Highlights*
  a regional supplement to *Current Issues*
- *Liberty Street Economics*
  a blog that enables our economists to engage with the public on diverse issues quickly and frequently
- *Staff Reports*
  technical papers intended for publication in leading economic and finance journals.

The Research Group also offers two other publications of interest to readers:

- *EPR Executive Summaries*
  online versions of selected *Economic Policy Review* articles, in abridged form
- *Research Update*
  an online quarterly newsletter providing summaries of studies and listings of recent publications in our research series.

Members of the Group also publish papers in many economic and finance journals, conference volumes, and scholarly books. A list of these publications begins on page 32.

Economic Policy Review

The *Economic Policy Review* is a policy-oriented research journal that focuses on macroeconomic, banking, and financial market topics.

EPR articles are available at **www.newyorkfed.org/research/epr**.

Volume 17

No. 1, May 2011

Special Issue: Federal Reserve Policy Responses to the Financial Crisis

Overview

Patricia C. Mosser

Central Bank Dollar Swap Lines and Overseas Dollar Funding Costs*

Linda S. Goldberg, Craig Kennedy, and Jason Miu

Following a scarcity of dollar funding available internationally to banks and financial institutions, in December 2007 the Federal Reserve began to establish or expand temporary reciprocal currency arrangements with fourteen foreign central banks. The central banks had the capacity to use these swap facilities to provide dollar liquidity to institutions in their jurisdictions. This paper describes developments in the dollar swap facilities through the end of 2009. The facilities were a response to dollar funding shortages outside the United States during a period of market dysfunction. Formal research, as well as more descriptive accounts, suggests that the dollar swap lines among central banks were effective at reducing the dollar funding pressures abroad and stresses in money markets. The dollar swap facilities are an important part of the central bank toolbox for managing systemic liquidity disruptions.

Commentary

Stijn Claessens

The Federal Reserve's Commercial Paper Funding Facility

Tobias Adrian, Karin Kimbrough, and Dina Marchioni

The Federal Reserve created the Commercial Paper Funding Facility (CPFF) in the midst of severe disruptions in money markets following the bankruptcy of Lehman Brothers on September 15, 2008. The CPFF finances the purchase of highly rated unsecured and asset-backed commercial paper from eligible issuers through primary dealers. The facility is a liquidity backstop to U.S. issuers of commercial paper, and its creation was part of a range of policy actions undertaken by the Federal Reserve to provide liquidity to the financial system. This study documents aspects of the financial crisis relevant to the creation of the CPFF, reviews the operation of the CPFF, discusses usage of the facility, and draws conclusions for lender-of-last-resort facilities in a market-based financial system.

Large-Scale Asset Purchases by the Federal Reserve: Did They Work?

Joseph Gagnon, Matthew Raskin, Julie Remache, and Brian Sack

Since December 2008, the Federal Reserve's traditional policy instrument, the target federal funds rate, has been effectively at its lower bound of zero. In order to further ease the stance of monetary policy as the economic outlook deteriorated, the Federal Reserve purchased substantial quantities of assets with medium and long maturities. This paper explains how these purchases were implemented and discusses the mechanisms through which they can affect the economy. The authors present evidence that the purchases led to economically meaningful and long-lasting reductions in longer-term interest rates on a

*A top download in 2011.

range of securities, including securities that were not included in the purchase programs. These reductions in interest rates primarily reflect lower risk premiums, including term premiums, rather than lower expectations of future short-term interest rates.

Forthcoming

Subprime Foreclosures and the 2005 Bankruptcy Reform

Donald P. Morgan, Benjamin Iverson, and Matthew Botsch

This article presents arguments and evidence suggesting that the bankruptcy abuse reform (BAR) of 2005 may have been one contributor to the destabilizing surge in subprime foreclosures. Before BAR took effect, overly indebted borrowers could file bankruptcy to free up income to pay their mortgage by having their credit card and other unsecured debts discharged. BAR eliminated that option for better-off filers through a means test and other requirements, thus making it harder to save one's home by filing bankruptcy. By way of evidence, the authors show that the impact of BAR was greater in U.S. states where one would expect it to have a larger impact—namely, in states with high bankruptcy exemptions. Filers in low-exemption states were not very protected before BAR, so they were less likely to be affected by the reform. The authors estimate that for a state with an average home equity exemption, the subprime foreclosure rate after BAR rose 11 percent relative to the average before the reform; given the number of subprime mortgages in the United States, that figure translates into 29,000 additional subprime foreclosures per quarter nationwide attributable to BAR.
EPR Executive Summary available

The Microstructure of the TIPS Market

Michael J. Fleming and Neel Krishnan

The potential advantages from the introduction of Treasury inflation-protected securities (TIPS) in 1997 have not been fully realized, mainly because TIPS are less liquid than nominal Treasury securities. The lack of liquidity is thought to adversely affect TIPS prices relative to prices of nominal securities, offsetting the benefits that come from TIPS having no inflation risk. Despite the importance of TIPS liquidity and the market's large size, there is virtually no quantitative evidence on the securities' liquidity. This article sheds light on this phenomenon using novel tick data from the interdealer market. The authors identify several features of the TIPS market also present in the nominal securities market, but some unique features as well. As in the nominal market, there is a marked difference in trading activity between the most recently issued ("on-the-run") and previously issued ("off-the-run") securities, as trading drops sharply when securities go off the run. In contrast to the nominal market, there is little difference in bid-ask spreads or quoted depth between these securities, but there is a difference in the incidence of posted quotes. These results suggest that trading activity and quote incidence may be better cross-sectional measures of liquidity in the TIPS market than bid-ask spreads or quoted depth. Intraday patterns of trading activity are broadly similar in both markets, but TIPS activity peaks somewhat later, likely reflecting differences in the use and ownership of these securities. Announcement effects also differ between markets, with TIPS auction results and CPI releases eliciting particularly strong increases in trading activity, likely indicating these announcements' special importance to TIPS valuation.
EPR Executive Summary available

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EPR Executive Summaries

Visit our website for concise summaries of *Economic Policy Review* articles.

Our online publication *EPR Executive Summaries* condenses many of the articles published in the *Review*. Readers will find timely, policy-oriented summaries that are easy to absorb.

The summaries make the technical research of New York Fed economists more accessible to policymakers, educators, business leaders, and others. The series is designed to foster a fuller understanding of our research among those who are in a position to put our ideas and findings to work.

Summaries are available for many articles published since 2002.

www.newyorkfed.org/research/epr/executive_summary.html

Current Issues in Economics and Finance

Current Issues in Economics and Finance offers concise studies of topical economic and financial issues.

Second District Highlights—a regional supplement to *Current Issues*—covers important financial and economic developments in the Federal Reserve System's Second District.

Both series are available at **www.newyorkfed.org/research/current_issues**.

Volume 17

No. 1, 2011

Income Effects of Federal Reserve Liquidity Facilities

Michael J. Fleming and Nicholas J. Klagge

One of the chief actions taken by the Federal Reserve in response to the financial crisis was the introduction or expansion of facilities designed to provide liquidity to the funding markets. A study of the programs suggests that the liquidity facilities generated $20 billion in interest and fee income between August 2007 and December 2009, or $13 billion after taking into account the estimated $7 billion cost of funds. Moreover, the Fed took important steps to limit the credit exposure it incurred in connection with the facilities.

No. 2, 2011

Help for Unemployed Borrowers: Lessons from the Pennsylvania Homeowners' Emergency Mortgage Assistance Program

James Orr, John Sporn, Joseph Tracy, and Junfeng Huang

In an environment of high foreclosure rates and distressed housing markets, federal policies are focusing on loan modifications to help delinquent homeowners pay their mortgages. While it is too soon to assess the effectiveness of these modifications, policymakers considering future refinements may gain insight from a more established, state-level enterprise that takes an alternative approach to mortgage relief. The Pennsylvania Homeowners' Emergency Mortgage Assistance Program provides temporary income support to homeowners unable to pay their mortgage during a spell of unemployment. The program has helped most participants retain their homes while paying off their loans—at a potentially lower cost than that of other relief initiatives.

No. 3, 2011

How Does Slack Influence Inflation?

Richard Peach, Robert Rich, and Anna Cororaton

Economists have long studied the relationship between resource utilization and inflation. Theory suggests that when firms use labor and capital very intensively, production costs tend to rise and firms have more scope to pass those cost increases along in the form of higher product prices. In contrast, when that level of intensity is relatively low—that is, when the economy is operating with slack—production costs tend to rise more slowly (or even fall) and firms have less scope for raising prices. Empirical evidence, however, has varied concerning the exact nature of the relationship between

resource utilization and inflation. In this study, the authors reexamine this relationship by evaluating the presence of "threshold effects." They find that the level of intensity of resource utilization must be below or above certain critical values before it can help to forecast movements in inflation.

No. 4, 2011

Why Small Businesses Were Hit Harder by the Recent Recession

Ayşegül Şahin, Sagiri Kitao, Anna Cororaton, and Sergiu Laiu

Although both large and small businesses felt the sting of job losses during the 2007-09 downturn, small firms experienced disproportionate declines. A study of the recession's employment effect on small firms suggests that poor sales and economic uncertainty were the main reasons for their weak performance and sluggish recovery—problems that affected large firms too, but to a lesser degree. Although a tightened credit supply constrained some small firms, weak consumer demand for the firms' products and services was a more pressing factor, reducing revenues and dampening new investment spending.

No. 5, 2011

Saving Imbalances and the Euro Area Sovereign Debt Crisis

Matthew Higgins and Thomas Klitgaard

For several years prior to 2010, countries in the euro area periphery engaged in heavy borrowing from foreign private investors, allowing domestic spending to outpace incomes. Now these countries face debt crises reflecting a loss of investor confidence in the sustainability of their finances. The result has been an abrupt halt in private foreign lending to these economies. This study explains how the periphery countries became dependent on foreign borrowing and considers the challenges they face reigniting growth while adjusting to greatly reduced access to foreign capital.

No. 6, 2011

The Role of Colleges and Universities in Building Local Human Capital

Jaison R. Abel and Richard Deitz

Colleges and universities can contribute to the economic success of a region by deepening the skills and knowledge—or human capital—of its residents. Producing graduates who join the region's educated workforce is one way these institutions increase human capital levels. In addition, the knowledge and technologies created through research activities at area universities may not only attract new firms to a region but also help existing businesses expand and innovate. These "spillover effects" can in turn raise the region's demand for high-skilled workers.

Second District Highlights

No. 7, 2011

Monetary Policy Implementation: Common Goals but Different Practices

Marlene Amstad and Antoine Martin

While the goals that guide monetary policy in different countries are very similar, central banks diverge in their methods of implementing policy. This study of the policy frameworks of four central banks—the Federal Reserve, the European Central Bank, the Bank of England, and the Swiss National Bank—focuses on two notable areas of difference. The first is the choice of an interest rate target, a standard feature of conventional monetary policy. The second is the choice of instruments for managing the central banks' expanded balance sheets—a decision made necessary by the banks' unconventional practice of acquiring large quantities of assets during the financial crisis.

Liberty Street Economics

The *Liberty Street Economics* blog, launched in March 2011, provides a way for our economists to engage with the public on diverse issues quickly and frequently. The blog typically publishes new economic posts twice a week, on Mondays and Wednesdays. It posts reader comments and author responses in the hope of generating a productive dialogue with the public.

Visit the blog at **libertystreeteconomics .newyorkfed.org/**.

Economic Posts in 2011

March 21
Have Consumers Been Deleveraging?
Meta Brown, Andrew Haughwout, Donghoon Lee, and Wilbert van der Klaauw

March 23
How Much Will the Rise in Commodity Prices Reduce Discretionary Income?
Jonathan McCarthy

March 28
How Were the Basel 3 Minimum Capital Requirements Calibrated?
Beverly Hirtle

March 30
Why Do Central Banks Have Discount Windows?
João Santos and Stavros Peristiani

April 4
CoVaR: A Measure of Systemic Risk
Tobias Adrian and Markus K. Brunnermeier

April 6
Temporary Layoffs during the Great Recession
Erica L. Groshen

April 11
Everything You Wanted to Know about the Tri-Party Repo Market, but Didn't Know to Ask
Lucinda Brickler, Adam Copeland, and Antoine Martin

April 13
Why Did U.S. Branches of Foreign Banks Borrow at the Discount Window during the Crisis?
Linda Goldberg and David Skeie

April 18
What Is Driving the Recent Rise in Consumer Inflation Expectations?
Giorgio Topa, Wilbert van der Klaauw, Olivier Armantier, and Basit Zafar

May 2
New York City's Economic Recovery—Main Street Gets the Jump on Wall Street
Jason Bram and James Orr

May 4
How Much Will the Second Round of Large-Scale Asset Purchases Affect Inflation and Unemployment?
Vasco Cúrdia and Andrea Ferrero

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Household Debt and Credit Developments in the Nation and the Region in 2011:Q1
Andrew Haughwout, Donghoon Lee, and Wilbert van der Klaauw

The Great Recession and Recovery in the Tri-State Region
Jason Bram and James Orr

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Why Are Adjustable Rate Mortgages So Rare These Days?
James Vickery

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Are Rising Commodity Prices Unanchoring Inflation Expectations?
Robert Rich, Joseph Song, and Joseph Tracy

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Will the Federal Reserve's Asset Purchases Lead to Higher Inflation?
Jamie McAndrews

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Valuing the Capital Assistance Program
Zhenyu Wang and Paul Glasserman

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Stress Test Success and Bank Opacity
Donald P. Morgan

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Did Unconventional Policy Responses to the Crisis Work? Evidence from a Cross-Country Analysis
Carlos Carvalho, Stefano Eusepi, and Christian Grisse

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Commodity Prices and the Mistake of 1937: Would Modern Economists Make the Same Mistake?
Gauti Eggertsson

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A Closer Look at the Recent Pickup in Inflation
John Sporn and Andrea Tambalotti

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Will "Quantitative Easing" Trigger Inflation?
Kenneth Garbade

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Lower-Income Households' Vulnerability to the Recent Commodity Price Surge
Jonathan McCarthy

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How Easy Is It to Forecast Commodity Prices?
Jan J. J. Groen and Paolo A. Pesenti

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Did Trade Finance Contribute to the Global Trade Collapse?
Mary Amiti and David Weinstein

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Marking the End of LSAP 2
Robert Rich

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Jonathan McCarthy

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Global Banks and Their Internal Capital Markets during the Crisis
Nicola Cetorelli and Linda S. Goldberg

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Would a Stronger Renminbi Narrow the U.S.-China Trade Imbalance?
Matthew Higgins and Thomas Klitgaard

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July's Empire State Manufacturing Survey Shows Ongoing Weakness in New York Manufacturing
Jason Bram and Richard Deitz

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Which Firms Have Flexible Prices?
Rebecca Hellerstein and Pinelopi Goldberg

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Stabilizing the Tri-Party Repo Market by Eliminating the "Unwind"
Antoine Martin

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The Vanishing U.S.-E.U. Employment Gap
Christian Grisse, Thomas Klitgaard, and Ayşegül Şahin

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Vivian Z. Yue and Leslie Shen

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David Lucca and Ernst Schaumburg

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Marco Del Negro, Fabrizio Perri, and Fabiano Schivardi

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A Look at the Accuracy of Policy Expectations
Richard Crump, Stefano Eusepi, and Emanuel Moench

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Rajashri Chakrabarti, Joydeep Roy, and Elizabeth Setren

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July's Indexes of Coincident Economic Indicators Show Economic Activity Picking Up across the Region
James Orr

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Local Hangovers: How the Housing Boom and Bust Affected Jobs in Metro Areas
Jaison R. Abel and Richard Deitz

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Olivier Armantier, Eric Ghysels, Asani Sarkar, and Jeffrey Shrader

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Helping Unemployed Borrowers Meet Their Mortgage Payments
James Orr and Joseph Tracy

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Consumer Goods from China Are Getting More Expensive
Mary Amiti and Mark Choi

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Can Speculative Trading Magnify Financial Market Co-movement?
Christian Grisse

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An Examination of U.S. Dollar Declines
Roosevelt D. Bowman and Jan J. J. Groen

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The Productivity Slowdown Reaffirmed
James Kahn and Robert Rich

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What If the U.S. Dollar's Global Role Changed?
Linda Goldberg, Mark Choi, and Hunter Clark

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How Well Do Financial Markets Separate News from Noise? Evidence from an Internet Blooper
Carlos Carvalho, Nicholas Klagge, and Emanuel Moench

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Did the Fed's Term Auction Facility Work?
James McAndrews, Asani Sarkar, and Zhenyu Wang

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Tanju Yorulmazer

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Back to the Future: Revisiting the European Crisis
Paolo Pesenti

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Money and Payments Workshop Examines Repo Market Reform
Gara Afonso and Antoine Martin

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Sizing Up the Fed's Maturity Extension Program
Katherine Femia, Jeff Huther, and Andrea Tambalotti

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Fed Proposes Simpler Rules for Banks' Reserve Requirements
Richard Roberts

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Using Crisis Losses to Calibrate a Regulatory Capital Buffer
Beverly Hirtle

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Remaining Risks in the Tri-Party Repo Market
Antoine Martin

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Conference on Global Systemic Risk Explores Four Key Questions
Tobias Adrian and Michael Abrahams

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The Debt Ceiling as a "Fiscal Rule"
Richard W. Peach

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The Evolution of Federal Debt Ceilings
Kenneth Garbade

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Why Is There a "Zero Lower Bound" on Interest Rates?
Todd Keister

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Job Polarization in the United States: A Widening Gap and Shrinking Middle
Jaison R. Abel and Richard Deitz

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How Might Increased Transparency Affect the CDS Markets?
Kathryn Chen, Michael Fleming, John Jackson, Ada Li, and Asani Sarkar

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Simon Potter

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Rajashri Chakrabarti and Noah Schwartz

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Designing Executive Compensation to Curb Bank Risk Taking
Hamid Mehran

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Andrew Haughwout, Donghoon Lee, Joseph Tracy, and Wilbert van der Klaauw

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When Do Trade Frictions Increase Liquidity?
Gara Afonso

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Matthew Higgins and Thomas Klitgaard

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Labor Force Exits Are Complicating Unemployment Rate Forecasts
Richard Peach, Josiah Bethards, and Joseph Song

Research Update

Research Update is an online quarterly newsletter designed to keep you informed about the Research Group's current work. The newsletter—which complements this catalogue—offers summaries of selected studies and listings of recent articles and papers in our research series.

Research Update also reports on other news within the Group, including:

- staff publication in outside journals,
- presentations by economists at academic conferences and industry gatherings,
- upcoming conferences at the Federal Reserve Bank of New York,
- calls for papers, and
- new publications and services.

The publication is available at **www.newyorkfed.org/research/research_update**.

Staff Reports

The *Staff Reports* series features technical research papers designed to stimulate discussion and elicit comments. These papers are intended for eventual publication in leading economic and finance journals.

The series is available only at **www.newyorkfed.org/research/staff_reports**.

Macroeconomics and Growth

No. 482, January 2011

Household Debt and Saving during the 2007 Recession

Rajashri Chakrabarti, Donghoon Lee, Wilbert van der Klaauw, and Basit Zafar

Using credit-report records and data collected from several household surveys, the authors analyze changes in household debt and saving during the 2007 recession. They find that the crisis' impact appears to have been widespread, affecting large shares of households across all age, income, and education groups. In response to their deteriorated financial situations, households reduced their average spending and increased their saving. This increase in saving—at least in 2009—did not materialize through an increase in contributions to retirement and savings accounts. Instead, the higher saving rate appears to reflect a considerable decline in household debt, as households paid down mortgage debt in particular. At the end of 2009, individuals expected to continue increasing their saving and paying down of debt, which is consistent with what the authors have observed so far in 2010. In contrast, consumers were pessimistic about the availability of credit, expecting it to become harder to obtain during 2010.

No. 483, January 2011

Stigma in Financial Markets: Evidence from Liquidity Auctions and Discount Window Borrowing during the Crisis

Olivier Armantier, Eric Ghysels, Asani Sarkar, and Jeffrey Shrader

The authors provide empirical evidence for the existence, magnitude, and economic impact of stigma associated with banks' borrowing from the Federal Reserve's discount window facility. They find that, during the height of the financial crisis, banks were willing to pay an average premium of at least 37 basis points (and 150 basis points after Lehman's bankruptcy) to borrow from the Term Auction Facility rather than from the discount window. The incidence of stigma varied according to bank characteristics and market conditions. Finally, Armantier et al. find that discount window stigma is economically relevant since it increased banks' borrowing costs during the crisis. The results have important implications for the provision of liquidity by central banks.

No. 489, April 2011

Expectations of Inflation: The Biasing Effect of Thoughts about Specific Prices

Wändi Bruine de Bruin, Wilbert van der Klaauw, and Giorgio Topa

Relatively little is known about how individuals form the inflation expectations they report on consumer surveys. The authors present two studies to examine whether individuals who consider specific price changes when forming their inflation expectations report more extreme and disagreeing inflation expectations due to focusing on specific extreme price changes. In Study 1, participants who were instructed to recall *any* price changes or to recall *the largest* price changes thought of various items for which price changes were perceived to have been extreme. They reported more extreme year-ahead inflation expectations and showed more disagreement than did a third group that had been asked to recall *the average* change in price changes. Study 2 asked participants to report their year-ahead inflation expectations, without first prompting them to recall specific price changes. Half of participants nevertheless thought of specific prices when generating their inflation expectations. The authors' findings provide new insights into expectation formation processes and have implications for the design of survey-based measures of inflation.

No. 495, May 2011

Sectoral Price Facts in a Sticky-Price Model

Carlos Carvalho and Jae Won Lee

The authors develop a multisector sticky-price DSGE model that can endogenously deliver differential responses of prices to aggregate and sectoral shocks. Input-output production linkages induce across-sector pricing complementarities that contribute to a slow response of prices to aggregate shocks. In turn, input-market segmentation at the sectoral level induces within-sector pricing substitutability, which helps the model deliver a fast response of prices to sector-specific shocks. Estimating the factor-augmented vector autoregression specification of Boivin, Giannoni, and Mihov on data generated by a parameterized version of Carvalho and Lee's model, the authors find results that resemble what they obtain with disaggregated data for the U.S. economy. They then employ Bayesian methods to estimate the model using aggregate and sectoral data, and find that it accounts extremely well for a wide range of sectoral price facts.

No. 497, May 2011

A Note on Bank Lending in Times of Large Bank Reserves

Antoine Martin, James McAndrews, and David Skeie

The amount of reserves held by the U.S. banking system reached $1.5 trillion in April 2011. Some economists argue that such a large quantity of bank reserves could lead to overly expansive bank lending as the economy recovers, regardless of the Federal Reserve's interest rate policy. In contrast, Martin, McAndrews, and Skeie show that the size of bank reserves has no effect on bank lending in a frictionless model of the current banking system, in which interest is paid on reserves and there are no binding reserve requirements. The authors also examine the potential for balance-sheet cost frictions to distort banks' lending decisions. They find that large reserve balances do not lead to excessive bank credit and may instead be contractionary.

No. 505, July 2011

Sustainable Social Security: Four Options

Sagiri Kitao

This paper presents four policy options to make Social Security sustainable under the coming demographic shift: 1) increase payroll taxes by 6 percentage points, 2) reduce the replacement rates of the benefit formula by one-third, 3) raise the normal retirement age from sixty-six to seventy-three, or 4) means-test the benefits and reduce them one-to-one with income. While all four policies achieve the same goal, their economic outcomes differ significantly. Options 2 and 3 encourage own savings, and capital stock is more than 10 percent higher than in the other two options. The payroll tax increase in option 1 discourages work effort, but means-testing the benefits, as outlined in option 4, yields the worst labor disincentives, especially among the elderly.

No. 509, August 2011

Inflation Expectations and Behavior: Do Survey Respondents Act on Their Beliefs?

Olivier Armantier, Wändi Bruine de Bruin, Giorgio Topa, Wilbert van der Klaauw, and Basit Zafar

The authors compare the inflation expectations reported by consumers in a survey with their behavior in a financially incentivized investment experiment designed such that future inflation affects payoffs. The inflation expectations survey is found to be informative in the sense that the beliefs reported by the respondents are correlated with their choices in the experiment. Furthermore, most respondents appear to act on their inflation expectations, showing patterns consistent (both in direction and magnitude) with expected utility theory. Respondents whose behavior cannot be rationalized tend to be less educated and to score lower on a numeracy and financial literacy scale. These findings are therefore the first to provide support to the microfoundations of modern macroeconomic models.

No. 515, September 2011

Learning the Fiscal Theory of the Price Level: Some Consequences of Debt Management Policy

Stefano Eusepi and Bruce Preston

This paper examines how the scale and composition of public debt can affect economies that implement a combination of "passive" monetary policy and "active" fiscal policy. This policy configuration is argued to be of both historical and contemporary interest in the cases of the U.S. and Japanese economies. It is shown that higher average levels and moderate average maturities of debt can induce macroeconomic instability under a range of policies specified as simple rules. However, interest rate pegs in combination with active fiscal policies almost always ensure macroeconomic stability. This finding suggests that in periods when the zero lower bound on nominal interest rates is a relevant constraint on policy design, a switch in fiscal regime is desirable.

No. 520, October 2011

The Great Escape? A Quantitative Evaluation of the Fed's Liquidity Facilities

Marco Del Negro, Gauti Eggertsson, Andrea Ferrero, and Nobuhiro Kiyotaki

The authors introduce liquidity frictions into an otherwise standard DSGE model with nominal and real rigidities, explicitly incorporating the zero bound on the short-term nominal interest rate. Within this framework, they ask: Can a shock to the liquidity of private paper lead to a collapse in short-term nominal interest rates and a recession like the one associated with the 2008 U.S. financial crisis? Once the nominal interest rate reaches the zero bound, what are the effects of interventions in which the government exchanges liquid government assets for illiquid private paper? The study finds that the effects of the liquidity shock can be large, and it provides some numerical examples of the liquidity facilities preventing a repeat of the Great Depression in 2008-09.

No. 524, November 2011

Optimal Disinflation under Learning

Timothy Cogley, Christian Matthes, and Argia M. Sbordone

The authors model transitional dynamics that emerge after the adoption of a new monetary policy rule. They assume that private agents learn about the new policy via Bayesian updating, and study how learning affects the nature of the transition and the choice of a new rule. Temporarily explosive dynamics can emerge when there is substantial disagreement between actual and perceived policies. These dynamics make the transition highly volatile and dominate expected loss. The emergence of temporarily explosive paths depends more on uncertainty about policy-feedback parameters than about the long-run inflation target. For that reason, the central bank can at least achieve low average inflation. Its ability to move feedback parameters away from initial beliefs, however, is more constrained.

No. 527, December 2011

The Macroeconomic Effects of Large-Scale Asset Purchase Programs

Han Chen, Vasco Cúrdia, and Andrea Ferrero

The effects of asset purchase programs on macroeconomic variables are likely to be moderate. The authors embed a preferred habitat framework in a standard DSGE model estimated on U.S. data and evaluate the effects of the Federal Reserve's second large-scale asset purchase program (LSAP 2). The simulations suggest that such a program increases GDP growth by less than half a percentage point, although the effect on the level of GDP is very persistent. The program's marginal contribution to inflation is minimal. The small estimated degree of financial market segmentation is crucial for the results. Augmenting the set of observables with a measure of long-term debt leads to even smaller macroeconomic effects of LSAP programs, as the authors find an elasticity of the risk premium to the quantity of debt substantially smaller than the recent empirical estimates suggest. Throughout the analysis, a commitment to an extended period at the zero lower bound for nominal interest rates increases the effects of asset purchase programs on GDP growth and inflation.

No. 531, December 2011

Some Unpleasant General Equilibrium Implications of Executive Incentive Compensation Contracts

John B. Donaldson, Natalia Gershun, and Marc P. Giannoni

The authors consider a simple variant of the standard real business cycle model in which shareholders hire a self-interested executive to manage the firm on their behalf. A generic family of compensation contracts similar to those employed in practice is studied. When compensation is convex in the firm's own dividend (or share price), a given increase in the firm's output generated by an additional unit of physical investment results in a more than proportional increase in the manager's income. Incentive contracts of sufficient yet modest convexity are shown to result in an indeterminate general equilibrium, one in which business cycles are driven by self-fulfilling fluctuations in the manager's expectations that are unrelated to the economy's fundamentals. Arbitrarily large fluctuations in macroeconomic variables may result. The study also provides a theoretical justification for the proposed family of contracts by demonstrating that they yield first-best outcomes for specific parameter choices.

International

No. 499, June 2011

Global Bond Risk Premiums

Rebecca Hellerstein

This paper examines time-varying measures of term premiums across ten developed economies. It shows that a single factor accounts for most of the variation in expected excess returns over time, across the maturity spectrum, and across countries. Hellerstein constructs a global return forecasting factor that is a GDP-weighted average of each country's local return forecasting factor and shows that it has information not spanned by the traditional level, slope, or curvature factors of the term structure, or by the local return forecasting factors. Including the global forecasting factor in the model produces estimates of spillover effects that are consistent with our conceptual understanding of these flows, both in direction and magnitude. These effects are illustrated for three episodes: the period following the Russian default in 1998, the bond conundrum period from mid-2004 to mid-2006, and the period since the onset of the global financial crisis in 2008.

No. 508, August 2011

The Dynamics and Differentiation of Latin American Metal Exports

Benjamin Mandel

This paper investigates the propensity of exporters in certain primary commodity sectors to innovate and then attempts to measure the associated gains. The high degree of differentiation in metal products is giving rise to the potential for vertical upgrading for a substantial portion of Latin American export sales. Estimation of a demand system for U.S. imports shows that relatively high-priced new varieties tend to gain market share, which suggests a correspondingly large increase in the relative quality of those varieties. Breaking down the types of metal products by order of their value-added in production reveals a pattern of specialization away from low-value ores and toward high-value intermediate and finished products. Upgrading varieties and shifting specialization to downstream outputs account for the vast majority of Latin America's increasing market share in metals over the past thirty years.

No. 511, August 2011

Liquidity Management of U.S. Global Banks: Internal Capital Markets in the Great Recession

Nicola Cetorelli and Linda Goldberg

The recent crisis highlighted the importance of globally active banks in linking markets. One channel for this linkage is the liquidity management of these banks, specifically the regular flow of funds between parent banks and their affiliates in diverse foreign markets. Cetorelli and Goldberg use the Great Recession as an opportunity to identify the balance-sheet shocks to parent banks in the United States and then explore which features of foreign affiliates are associated with protecting, for example, their status as important locations in sourcing funding or as destinations for foreign investment activity. The authors show that distance

from the parent organization plays a significant role in this allocation, where distance is bank-affiliate-specific and depends on the location's ex ante relative importance in local funding pools and overall foreign investment strategies. These flows are a form of global interdependence previously unexplored in the literature on international shock transmission.

No. 522, October 2011

The International Role of the Dollar: Does It Matter if This Changes?

Linda Goldberg

There is often speculation that the international roles of currencies may be changing. This paper presents the current status of these roles. The U.S. dollar continues to be the dominant currency across various uses. Yet such a role may change over time. If this occurs, there could be consequences for seignorage returns, U.S. funding costs, the dollar's value, U.S. insulation from foreign shocks, and U.S. global influence. The paper concludes with a discussion of recent research on related themes and questions for future study.

Microeconomics

No. 486, March 2011

Vouchers, Responses, and the Test-Taking Population: Regression Discontinuity Evidence from Florida

Rajashri Chakrabarti

This paper analyzes a Florida program that embedded vouchers in an accountability regime. Specifically, it investigates whether the threat of vouchers and the stigma associated with the Florida program induced schools to strategically manipulate their test-taking population. Under Florida rules, scores of students in several special-education and limited-English-proficient (LEP) categories were not included in the computation of school grades. Did this rule induce the threatened schools to reclassify some of their weaker students into these "excluded" categories so as to remove them from the effective test-taking pool? Using a regression discontinuity strategy, Chakrabarti finds evidence in favor of strategic reclassification into the excluded LEP category in high-stakes grade 4 and entry-grade 3. In contrast, she finds no evidence that the program led to reclassification into excluded special-education categories, which is consistent with the substantial costs of classifying into special-education categories during this period. These findings have important policy implications.

No. 490, April 2011

Robust Capital Regulation

Viral Acharya, Hamid Mehran, Til Schuermann, and Anjan Thakor

Banks' leverage choices represent a delicate balancing act. Credit discipline argues for more leverage, while balance-sheet opacity and ease of asset substitution argue for less. Meanwhile, regulatory safety nets promote ex post financial stability, but also create perverse incentives for banks to engage in correlated asset choices and to hold little equity capital. As a way to cope with these distorted incentives, the authors outline a two-tier capital framework for banks. The first tier is a regular core capital requirement that helps deter excessive risk-taking incentives. The second tier, a novel aspect of their framework, is a special capital account that limits risk taking but preserves creditors' monitoring incentives.

No. 500, June 2011

Determinants of College Major Choice: Identification Using an Information Experiment

Matthew Wiswall and Basit Zafar

This paper studies the determinants of college major choice using a unique "information" experiment embedded in a survey. Wiswall and Zafar ask respondents about their beliefs—about their own expected earnings and other major-specific outcomes conditional on various majors, about the population distribution of these characteristics, as well as whether they believe they will graduate with each major. The authors then provide students with information on the true population distribution of these characteristics, and observe how this new information causes respondents to update their beliefs. The experimental design creates unique panel data. Wiswall and Zafar show that respondents make substantial errors in population beliefs, and logically revise their self-beliefs in response to the information. Subjective beliefs about future major choice are positively and strongly associated with beliefs about self-earnings, ability, and spouse's earnings. However, cross-sectional estimates are severely biased upward because of the positive correlation of tastes with earnings and ability. The experimental variation in beliefs allows the authors to identify a rich model of college major choice, with which they estimate the relative importance of earnings and earnings uncertainty on the choice of college major versus other factors.

No. 501, June 2011

Stereotypes and Madrassas: Experimental Evidence from Pakistan

Adeline Delavande and Basit Zafar

Madrassas (Islamic religious seminaries) are thought to be responsible for fostering Islamic extremism and violence and for indoctrinating their students in narrow worldviews. However, little is known about the behavior of madrassa students, and how other groups in their communities interact with them. To investigate, the authors collect unique experimental and survey data from madrassas and other educational institutions in Pakistan. They randomly match male students from institutions of three distinct religious tendencies and socioeconomic background—madrassas, Islamic universities, and liberal universities—and observe their actions in several experiments of economic decisionmaking. First, the authors find a high level of trust among all groups, with students enrolled at madrassas being the most trusting and exhibiting the highest level of unconditional other-regarding behavior. Second, within each group, the authors fail to find evidence of in-group bias or systematic out-group bias either in trust or tastes. Third, the authors find that students of liberal universities underestimate the trustworthiness of madrassa students.

No. 506, July 2011

Repo Runs: Evidence from the Tri-Party Repo Market

Adam Copeland, Antoine Martin, and Michael Walker

This paper provides a quantitative account of the tri-party repo market during the recent financial crisis. Using data from July 2008 to January 2010, the authors show that the level of haircuts and the amount of funding were surprisingly stable in this market. The stability of the haircuts contrasts with evidence from the bilateral repo market, where, as shown by Gorton and Metrick, haircuts increased sharply. During the crisis, adjustments in the volume of funding to dealers were not gradual; instead, the amount of funding in the tri-party repo market can decrease precipitously. The paper's findings suggest that runs in the tri-party repo market resemble traditional bank runs.

No. 514, September 2011

Real Estate Investors, the Leverage Cycle, and the Housing Market Crisis

Andrew Haughwout, Donghoon Lee, Joseph Tracy, and Wilbert van der Klaauw

The authors explore a mostly undocumented but important dimension of the housing market crisis: the role played by real estate investors. Using unique credit-report data, they document large increases in the share of purchases, and subsequently delinquencies, by real estate investors. In states that experienced the largest housing booms and busts, at the peak of the market almost half of purchase mortgage originations were associated with investors. In part by apparently misreporting their intentions to occupy the property, investors took on more leverage, contributing to higher rates of default. The study's findings have important implications for policies designed to address the consequences and recurrence of housing market bubbles.

No. 516, September 2011

Belief Updating among College Students: Evidence from Experimental Variation in Information

Matthew Wiswall and Basit Zafar

Wiswall and Zafar investigate how college students form and update their beliefs about future earnings using a unique "information" experiment. They provide college students true information about the population distribution of earnings and observe how this information causes respondents to update their beliefs about their own future earnings. Wiswall and Zafar show that college students are substantially misinformed about population earnings and logically revise their self-beliefs in response to the information the authors provide, with larger revisions when the information is more specific and is good news. The authors classify the updating behaviors observed and find that the majority of students are non-Bayesian updaters.

No. 523, October 2011

Do We Know What We Owe? A Comparison of Borrower- and Lender-Reported Consumer Debt

Meta Brown, Andrew Haughwout, Donghoon Lee, and Wilbert van der Klaauw

The authors compare household debt as reported by borrowers to the Survey of Consumer Finances (SCF) with household debt as reported by lenders to Equifax using the new FRBNY Consumer Credit Panel (CCP). Moments of the borrower and lender debt distributions are compared by year, age of household head, household size, and region of the country, in total and across five standard debt categories. The debt reports are strikingly similar, with one noteworthy exception: the aggregate credit card debt implied by SCF borrowers' reports is less than 50 percent of the aggregate credit card debt implied by CCP lenders' reports. Adjustments for sample representativeness and for small business and convenience uses of credit cards raise SCF credit card debt to somewhere between 52 and 66 percent of the CCP figure. Despite the credit card debt mismatch, bankruptcy history is reported comparably in the borrower and lender sources, indicating that not all stigmatized consumer behaviors are underreported.

No. 525, November 2011

Incentives and Responses under *No Child Left Behind*: Credible Threats and the Role of Competition

Rajashri Chakrabarti

The *No Child Left Behind* law mandated the institution of adequate yearly progress (AYP) objectives, on which schools are assigned a pass or fail. Chakrabarti studies the incentives and responses of schools that failed AYP once. Using regression discontinuity designs, she finds evidence in these schools of improvements in high-stakes reading and spillover effects to low-stakes language arts. The patterns are consistent with a focus on marginal students around the high-stakes cutoff, but this improvement did not come at the expense of the ends. Meanwhile, there is little evidence of improvement in high-stakes math or in low-stakes science and social studies. Performance in low-stakes grades suffered, as did performance in weaker subgroups despite their inclusion in AYP computations. Finally, there is strong evidence in favor of response to incentives: Schools that failed AYP only in reading and/or math subsequently did substantially better in those subject areas. Credibility of threat mattered. AYP-failed schools that faced more competition responded both more strongly and more broadly.

No. 530, December 2011

What Do Drug Monopolies Cost Consumers in Developing Countries?

Rebecca Hellerstein

This paper quantifies the effects of drug monopolies and low per capita income on pharmaceutical prices in developing economies using the example of the antiretroviral drugs used to treat HIV.

No. 534, December 2011

The Impact of the Great Recession on School District Finances: Evidence from New York

Rajashri Chakrabarti and Elizabeth Setren

Despite education's fundamental role in human capital formation and growth, there is no research that examines the effect of the Great Recession (or any other recession) on schools. This paper begins to fill this gap. Exploiting detailed data on school finance indicators and an analysis of trend shifts, the authors examine how the Great Recession affected school funding in New York State. While they find no evidence of effects on either total revenue or expenditure, they identify important compositional changes to both. There is strong evidence of substitution of funds on the revenue side—the infusion of funds from the federal stimulus occurred simultaneously with statistically and economically significant cuts in state and local financing, especially the former. On the expenditure side, instructional expenditure was maintained, while other categories such as transportation, student activities, and utilities suffered. Important heterogeneities in experiences are also observed by poverty level, metropolitan area, school district size, and urban status. These findings promise to facilitate an understanding of how recessions affect schools and of the role policy can play in mitigating the consequences.

Banking and Finance

No. 481, January 2011

Responses to the Financial Crisis, Treasury Debt, and the Impact on Short-Term Money Markets

Warren B. Hrung and Jason S. Seligman

Several programs have been introduced by U.S. fiscal and monetary authorities in response to the financial crisis. Hrung and Seligman examine the responses involving Treasury debt—the Term Securities Lending Facility (TSLF), the Supplemental Financing Program, increases in Treasury issuance, and open market operations—and their impacts on the overnight Treasury general collateral repo rate, a key money market rate. The study's contribution is to consider each policy in light of the others, both to help guide policy responses to future crises and to emphasize policy interactions. Only the TSLF was designed to directly address stresses in short-term money markets by temporarily changing the supply of Treasury collateral in the marketplace. The authors find that the TSLF is uniquely effective relative to other policies and that, while changes in Treasury collateral do affect repo rates, the impacts are not equivalent across sources of Treasury collateral.

No. 484, February 2011

Comovement Revisited

Maria Kasch and Asani Sarkar

This paper finds, unlike earlier studies, that there is no rise in the market betas of stocks that enter the S&P 500 index when the estimated factor model is that of Fama and French. Kasch and Sarkar also find that SMB and HML factor betas decline after the stocks are added to the index. This decline is explained by strong increases in earnings and in the market value of the event stocks in the period around—and, in particular, prior to—their inclusion in the index. The authors suggest that inclusions to the S&P 500 index are informative events that trigger a reassessment of the risk of newly added firms by drawing the broad market's attention to their extraordinary growth in size and profitability.

No. 485, February 2011

Basel 3: Long-Term Impact on Economic Performance and Fluctuations*

Paolo Angelini, Laurent Clerc, Vasco Cúrdia, Leonardo Gambacorta, Andrea Gerali, Alberto Locarno, Roberto Motto, Werner Roeger, Skander Van den Heuvel, and Jan Vlček

The authors assess the long-term economic impact of s the impact of the reform on long-term economic performance? 2) What is the impact of the reform on economic fluctuations? 3) What is the impact of the adoption of countercyclical capital buffers on economic fluctuations? The main results are: 1) Each percentage point increase in the capital ratio causes a median 0.09 percent decline in the level of steady-state output, relative to the baseline; the impact of the new liquidity regulation is of a similar order of magnitude, at 0.08 percent. 2) The reform should dampen output volatility; the magnitude of the effect is heterogeneous across models; the median effect is modest. 3) The adoption of countercyclical capital buffers could have a more sizable dampening effect on output volatility.

*A top download in 2011.

No. 487, March 2011

Central Bank Transparency and the Crowding Out of Private Information in an Experimental Asset Market

Menno Middeldorp and Stephanie Rosenkranz

Central banks have become increasingly communicative. An important reason is that democratic societies expect more transparency from public institutions. Central bankers, based on empirical research, also believe that sharing information has economic benefits. Communication is seen as a way to improve the predictability of monetary policy, thereby lowering financial market volatility and contributing to a more stable economy. However, a potential side-effect of providing costless public information is that market participants may be less inclined to invest in private information. Theoretical results suggest that this can hamper the ability of markets to predict future monetary policy. The authors test this in a laboratory asset market. Crowding out of information acquisition does indeed take place, but only where it is most pronounced does the predictive ability of the market deteriorate. Notable features of the experiment include a complex setup based directly on the theoretical model and the calibration of experimental parameters using empirical measurements.

No. 488, March 2011

Liquidity Hoarding

Douglas Gale and Tanju Yorulmazer

Banks hold liquid and illiquid assets. An illiquid bank that receives a liquidity shock sells assets to liquid banks in exchange for cash. Gale and Yorulmazer characterize the constrained efficient allocation as the solution to a planner's problem and show that the market equilibrium is constrained inefficient, with too little liquidity and inefficient hoarding. Their model features a precautionary as well as a speculative motive for hoarding liquidity, but the inefficiency of liquidity provision can be traced to the incompleteness of markets (due to private information) and the increased price volatility that results from trading assets for cash.

No. 491, April 2011

FOMC Communication Policy and the Accuracy of Fed Funds Futures

Menno Middeldorp

Over the last two decades, the Federal Open Market Committee (FOMC), the rate-setting body of the U.S. Federal Reserve System, has become increasingly communicative and transparent. According to policymakers, one of the goals of this shift has been to improve monetary policy predictability. Previous academic research has found that the FOMC has indeed become more predictable. Middeldorp contributes to the literature in two ways. First, instead of simply looking at predictability before and after the Fed's communication reforms in the 1990s, he identifies three distinct periods of reform and measures their separate contributions. Second, he corrects the interest rate forecasts embedded in fed funds futures contracts for risk premiums, in order to obtain a less biased measure of predictability. The author's results suggest that the communication reforms of the early 1990s and the "guidance" provided from 2003 significantly improved predictability, while the release of the FOMC's policy bias in 1999 had no measurable impact. Finally, Middeldorp finds that FOMC speeches and testimonies significantly lower short-term forecasting errors.

No. 492, May 2011

Bank Capital Regulation and Structured Finance

Antoine Martin and Bruno M. Parigi

The authors construct a model in which bank capital regulation and financial innovation interact. Innovation takes the form of pooling and tranching of assets and the creation of separate structures with different seniority, different risk, and different capital charges, a process that captures some stylized features of structured finance. Regulation is motivated by the divergence of private and social interests in future profits. Capital regulation lowers bank profits and may induce banks to innovate in order to evade the regulation itself. The study shows that structured finance can improve welfare in some cases. However, innovation may also be adopted to avoid regulation, even in cases where it decreases welfare.

No. 494, May 2011

Are Credit Default Swaps Associated with Higher Corporate Defaults?

Stavros Peristiani and Vanessa Savino

Using a proportional hazard model of bankruptcy and Merton's contingent-claims approach, Peristiani and Savino estimate the probability of default for U.S. nonfinancial firms. Their analysis does not generally find a persistent link between CDS and default over the entire 2001-08 period, but it does reveal a higher probability of default for firms with CDS over the last few years of that period. Further, the authors find that firms trading in the CDS market exhibited a higher Moody's KMV expected default frequency during 2004-08. These findings are consistent with those of Henry Hu and Bernard Black, who argue that agency conflicts between hedged creditors and debtors would increase the likelihood of corporate default. In addition, the paper highlights other explanations for the higher defaults of CDS firms. Consistent with fire-sale spiral theories, the authors find a positive link between institutional ownership exposure and corporate distress, with CDS firms facing stronger selling pressures during the recent financial turmoil.

No. 496, May 2011

Central Bank Transparency, the Accuracy of Professional Forecasts, and Interest Rate Volatility

Menno Middeldorp

Central banks worldwide have become more transparent. An important reason is that democratic societies expect more openness from public institutions. Policymakers also see transparency as a way to improve the predictability of monetary policy, thereby lowering interest rate volatility and contributing to economic stability. Most empirical studies support this view. However, there are three reasons why more research is needed. First, some (mostly theoretical) work suggests that transparency has an adverse effect on predictability. Second, empirical studies have mostly focused on average predictability before and after specific reforms in a small set of advanced economies. Third, less is known about the effect on interest rate volatility. To extend the literature, Middeldorp uses the Dincer and Eichengreen transparency index for twenty-four economies of varying income and examines the impact of transparency on both predictability and market volatility. He finds that higher transparency improves the accuracy of interest rate forecasts for three months ahead and reduces rate volatility.

No. 498, May 2011

A Model of Liquidity Hoarding and Term Premia in Interbank Markets

Viral V. Acharya and David Skeie

Financial crises are associated with reduced volumes of, and extreme levels of rates for, term interbank loans, as reflected in the one-month and three-month Libor. This study explains such stress by modeling leveraged banks' precautionary demand for liquidity. Asset shocks impair a bank's ability to roll over debt because of agency problems associated with high leverage. In turn, banks hoard liquidity and decrease term lending as their rollover risk increases over the term of the loan. High levels of short-term leverage and illiquidity of assets lead to low volumes and high rates for term borrowing. In extremis, interbank markets can completely freeze.

No. 502, June 2011

Corporate Governance and Banks: What Have We Learned from the Financial Crisis?

Hamid Mehran, Alan Morrison, and Joel Shapiro

Recent academic work and policy analysis give insight into the governance problems exposed by the financial crisis and suggest possible solutions. The authors begin by explaining why governance of banks differs from governance of nonfinancial firms. They then look at four areas of governance: executive compensation, boards, risk management, and market discipline. The paper discusses promising solutions and areas where further research is needed.

No. 512, August 2011

The Pre-FOMC Announcement Drift

David O. Lucca and Emanuel Moench

Since the Federal Open Market Committee (FOMC) began announcing its policy decisions in 1994, U.S. stock returns have on average been more than thirty times larger on announcement days than on other days. Surprisingly, these abnormal returns are accrued before the policy announcement. The excess returns earned during the twenty-four hours prior to scheduled FOMC announcements account for more than 80 percent of the equity premium over the past seventeen years. Similar results are found for major global equity indexes, but not for other asset classes or other economic news announcements. This paper explores a few risk-based explanations of these findings, none of which can account for the return anomaly.

No. 513, September 2011

Decomposing Short-Term Return Reversal

Zhi Da, Qianqiu Liu, and Ernst Schaumburg

The profit to a standard short-term return reversal strategy can be decomposed analytically into four components: 1) across-industry return momentum, 2) within-industry variation in expected returns, 3) underreaction to within-industry cash flow news, and 4) a residual. Only the residual component, which isolates reaction to recent "nonfundamental" price changes, is significant and positive in the data. A simple short-term return reversal trading strategy designed to capture the residual component generates a highly significant risk-adjusted return three times the size of the standard reversal strategy during the authors' 1982-2009 sampling period. Their decomposition suggests that short-term return reversal is pervasive, much greater than previously documented, and driven by investor sentiment on the short side and liquidity shocks on the long side.

No. 517, September 2011

An Analysis of CDS Transactions: Implications for Public Reporting*

Kathryn Chen, Michael Fleming, John Jackson, Ada Li, and Asani Sarkar

This paper analyzes three months of global credit default swap (CDS) transactions and presents findings on the market composition, trading dynamics, and level of standardization. The authors find that trading activity in the CDS market is relatively low, with a majority of reference entities for single-name CDS trading less than once a day. They also find that a high proportion of CDS transactions conform to standardized contractual and trading conventions. Examining the dealer's role as market maker, they find that large trades with customers are generally not rapidly offset by further trades in the same reference entity, suggesting that hedging of large positions, if taking place, occurs over a longer time horizon. The authors provide a framework for regulators and policymakers to consider the design of the public reporting regime and the necessary improvements to data collection to facilitate meaningful price reporting for credit derivatives.

No. 518, September 2011

Market Declines: Is Banning Short Selling the Solution?

Robert Battalio, Hamid Mehran, and Paul Schultz

In response to the sharp decline in prices of financial stocks in the fall of 2008, regulators in a number of countries banned short selling of particular stocks and industries. Evidence suggests that these bans did little to stop the slide in stock prices, but significantly increased the costs of liquidity. In August 2011, the U.S. market experienced a large decline when Standard and Poor's announced a downgrade of U.S. debt. This study's cross-sectional tests suggest that the decline in stock prices was not significantly driven or amplified by short selling. Short selling does not appear to be the root cause of recent stock market declines. Furthermore, banning short selling does not appear to prevent stock prices from falling when firm-specific or economy-wide economic fundamentals are weak, and may impose high costs on market participants.

No. 519, October 2011

Expectations versus Fundamentals: Does the Cause of Banking Panics Matter for Prudential Policy?

Todd Keister and Vijay Narasiman

There is a longstanding debate about whether banking panics and other financial crises always have fundamental causes or are sometimes the result of self-fulfilling beliefs. Disagreement on this point would seem to present a serious obstacle to designing policies that promote financial stability. However, Keister and Narasiman show that the appropriate choice of policy is invariant to the underlying cause of banking panics in some situations. In their model, the anticipation of being bailed out in the event of a crisis distorts the incentives of financial institutions and their investors. Two policies that aim to correct this distortion are compared: restricting policymakers from engaging in bailouts, and allowing bailouts but taxing the short-term liabilities of financial institutions. The authors find that the latter policy yields higher equilibrium welfare regardless of whether panics are sometimes caused by self-fulfilling beliefs.

*A top download in 2011.

No. 526, November 2011

Housing Busts and Household Mobility: An Update

Fernando Ferreira, Joseph Gyourko, and Joseph Tracy

This paper provides updated estimates of the impact of three financial frictions—negative equity, mortgage lock-in, and property tax lock-in—on household mobility. Ferreira, Gyourko, and Tracy add the 2009 wave of the American Housing Survey (AHS) to their sample and create an improved measure of permanent moves in response to Schulhofer-Wohl's critique of their earlier work. The authors' updated estimates corroborate their previous results: Negative equity reduces household mobility by 30 percent, and $1,000 of additional mortgage or property tax costs reduces household mobility by 10 to 16 percent. Schulhofer-Wohl's finding of a slight positive correlation between mobility and negative equity appears due to a large fraction of false positives, as his coding methodology has the propensity to misclassify almost half of the additional moves it identifies relative to the authors' measure of permanent moves. This also makes his mobility measure dynamically inconsistent, as many transitions originally classified as a move are reclassified as a nonmove when additional AHS panels become available. The study concludes with directions for future research, including potential improvements to measures of household mobility.

No. 528, December 2011

Which Financial Frictions? Parsing the Evidence from the Financial Crisis of 2007-09

Tobias Adrian, Paolo Colla, and Hyun Song Shin

The financial crisis of 2007-09 has sparked keen interest in models of financial frictions and their impact on macro activity. Most models share the feature that borrowers suffer a contraction in the quantity of credit. However, the evidence suggests that although bank lending contracted during the crisis, bond financing actually increased to make up much of the gap. This paper reviews both aggregate and micro-level data and highlights the shift in the composition of credit between loans and bonds. Motivated by the evidence, the authors formulate a model of direct and intermediated credit that captures the key stylized facts. In their model, the impact on real activity comes from the spike in risk premiums rather than the contraction in the total quantity of credit.

No. 529, December 2011

Repo and Securities Lending

Tobias Adrian, Brian Begalle, Adam Copeland, and Antoine Martin

Adrian et al. provide an overview of the data requirements necessary to monitor repurchase agreements (repos) and securities lending markets for the purposes of informing policy-makers and researchers about firm-level and systemic risk. They start by explaining the functioning of these markets, then argue that it is crucial to understand the institutional arrangements. Data collection is currently incomplete. A comprehensive collection should include six characteristics of repo and securities lending trades at the firm level: principal amount, interest rate, collateral type, haircut, tenor, and counterparty.

Introduction
Economic Policy Review
Current Issues
Liberty Street Economics
Research Update
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Outside Journals

No. 532, December 2011

Financial Intermediary Balance-Sheet Management

Tobias Adrian and Hyun Song Shin

Conventional discussions of balance-sheet management by nonfinancial firms take the set of positive net present value (NPV) projects as given, which in turn determines the size of the firm's assets. The focus is on the composition of equity and debt in funding such assets. In contrast, the balance-sheet management of financial intermediaries reveals that it is equity that behaves like the predetermined variable, and the asset size of the bank or financial intermediary is determined by the degree of leverage that is permitted by market conditions. The relative stickiness of equity reveals possible nonpecuniary benefits to bank owners so that they are reluctant to raise new equity, even during boom periods when raising equity is associated with less stigma and, hence, smaller discounts. Adrian and Shin explore the empirical evidence for both market-based financial intermediaries, such as the Wall Street investment banks, as well as the commercial bank subsidiaries of the large U.S. bank holding companies. They further explore the aggregate consequences of such behavior by the banking sector for the propagation of the financial cycle and securitization.

No. 533, December 2011

Dodd-Frank One Year On: Implications for Shadow Banking

Tobias Adrian

One year after passage of the Dodd-Frank Act (DFA), regulators proposed several rules required for its implementation. This paper discusses some aspects of proposed DFA rules in light of shadow banking. The topics are risk-retention rules for securitized products and the impact of capital reforms on asset-backed commercial paper (ABCP) conduits. While securitization reform is resulting primarily from DFA, changes in accounting standards, together with the Basel capital reforms, have had important impacts on the economics of ABCP conduits.

Quantitative Methods

No. 493, May 2011

Efficient Regression-Based Estimation of Dynamic Asset Pricing Models

Tobias Adrian, Richard K. Crump, and Emanuel Moench

Adrian, Crump, and Moench study regression-based estimators for beta representations of dynamic asset pricing models with affine and exponentially affine pricing kernel specifications. These estimators extend static cross-sectional asset pricing estimators to settings where prices of risk vary with observed state variables. The authors identify conditions under which four-stage regression-based estimators are efficient and also present alternative, closed-form linearized maximum likelihood (LML) estimators. They provide multi-stage standard errors necessary to conduct inference for asset pricing tests. In empirical applications, the paper finds that time-varying prices of risk are pervasive, thus favoring dynamic cross-sectional asset pricing models over standard unconditional specifications.

No. 503, July 2011

The Production Impact of "Cash-for-Clunkers": Implications for Stabilization Policy

Adam Copeland and James Kahn

Stabilization policies frequently aim to boost spending as a means to increase GDP. Spending does not necessarily translate into production, however, especially when inventories are involved. Copeland and Kahn look at the "cash-for-clunkers" program that helped finance the purchase of nearly 700,000 vehicles in 2009. An analysis of auto sales and production movements reveals that the program did prompt a large spike in sales. But the program had only a modest and fleeting impact on production, as inventories buffered the movements in sales. These findings suggest caution in judging the efficacy of such policies by their impact on spending alone.

No. 504, July 2011

The Empirical Content of Models with Multiple Equilibria in Economies with Social Interactions

Alberto Bisin, Andrea Moro, and Giorgio Topa

The authors study a general class of models with social interactions that might display multiple equilibria. They propose an estimation procedure for these models and evaluate its efficiency and computational feasibility relative to different approaches taken to the curse of dimensionality implied by the multiplicity. Using data on smoking among teenagers, the authors implement the proposed estimation procedure to understand how group interactions affect health-related choices. The study finds that interaction effects are strong both at the school level and at the smaller friends-network level. Multiplicity of equilibria is pervasive at the estimated parameter values, and equilibrium selection accounts for about 15 percent of the observed smoking behavior. Counterfactuals show that student interactions, surprisingly, reduce smoking by approximately 70 percent with respect to the equilibrium smoking that would occur without interactions.

No. 507, August 2011

Mapping Change in the Federal Funds Market

Morten L. Bech, Carl T. Bergstrom, Rodney J. Garratt, and Martin Rosvall

The authors use an information-theoretic approach to describe changes in lending relationships between federal funds market participants around the time of the Lehman Brothers failure. Unlike previous work that conducts maximum-likelihood estimation on undirected networks, their analysis distinguishes between borrowers and lenders and looks for broader lending relationships (multi-bank lending cycles) that extend beyond the immediate counterparties. The study finds that significant changes in lending patterns emerge following implementation of the Interest on Reserves policy by the Federal Reserve on October 9, 2008.

No. 510, August 2011

Evaluating Interest Rate Rules in an Estimated DSGE Model

Vasco Cúrdia, Andrea Ferrero, Ging Cee Ng, and Andrea Tambalotti

The empirical DSGE literature pays surprisingly little attention to the behavior of the monetary authority. Alternative policy rule specifications abound, but their relative merit is rarely discussed. This paper contributes to filling this gap by comparing the fit of a large set of interest rate rules (fifty-five in total), which it estimates within a simple New Keynesian model. The authors find that specifications in which monetary policy responds to inflation and to deviations of output from its efficient level—the one that would prevail in the absence of distortions—have the worst fit within the set they consider. Policies that respond to measures of the output gap based on statistical filters perform better, but the best-fitting rules are those that also track the evolution of the model-consistent efficient real interest rate.

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Early Contract Renegotiation: An Analysis of U.S. Labor Contracts from 1970 to 1995

Robert Rich and Joseph Tracy

This paper examines the ex post flexibility of U.S. labor contracts during the 1970-95 period by investigating whether unanticipated changes in inflation increase the likelihood of a contract being renegotiated prior to its expiration. Rich and Tracy find strong empirical support for this hypothesis. Specifically, their results indicate that renegotiations are triggered principally by large and infrequent price shocks of either sign. When combined with evidence that ex ante contract durations are shorter during episodes of increased inflation uncertainty, the results suggest that these contracts are flexible both ex ante and ex post to changes in the evolution of inflation.

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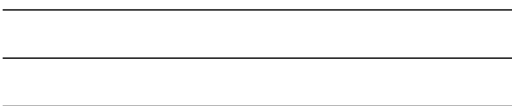

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